

# Economic Conditions and Emerging Risks in Banking

## The Economy Continues to Grow, but Energy Costs Are a Risk

### The Economy Continues to Grow, but High Energy Costs Pose a Risk

- Economic growth slowed in the second quarter as consumer spending grew at a much slower pace.
- However, renewed price cutting and incentives at dealerships lifted vehicle sales and helped boost overall consumer spending growth to a 4.6 percent annualized rate in the third quarter.
- Current forecasts call for real GDP growth to average 4 percent in 2005.
- Persistently high energy prices remain a serious risk to this forecast.

### The Business Sector Is Moving Forward...

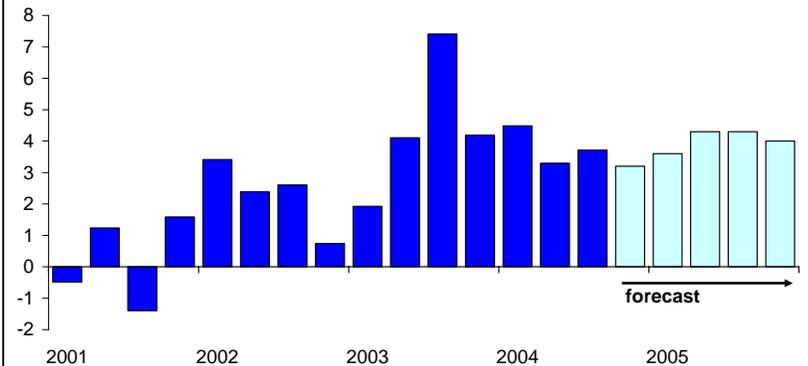
- Business investment continues to climb, up 11 percent during the first half of 2004 from a year ago.
- The ISM manufacturing and services surveys continue to sit well above 50, indicating net expansion in business sector output.
- Even motor vehicle production, which declined steadily between February and July, bounced back in late summer.
- Strong order growth and building order books (rising backlogs) suggest that business investment and factory output will remain strong.

### ...but Doubts Linger

- Despite solid business conditions, corporate profit growth appears set to slow to single-digit rates.
- High energy costs are one factor weighing on profits for non-energy firms.
- Rising unit labor costs will be another factor weighing on corporate profitability going forward, as the pace of hiring has picked up and growth in labor productivity has slowed.

**Real U.S. economic growth is currently expected to average about 4 percent in 2005.**

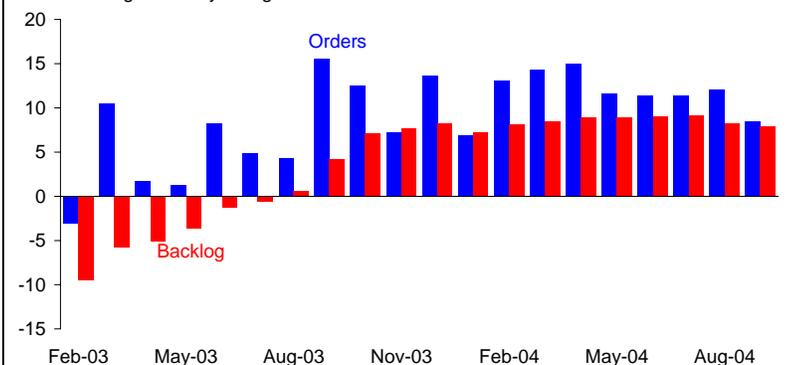
Real Gross Domestic Product (GDP)  
Quarterly percent change at annual rate



Source: Bureau of Economic Analysis, Macroeconomic Advisers forecast

**Strong order books suggest business investment and output will remain strong.**

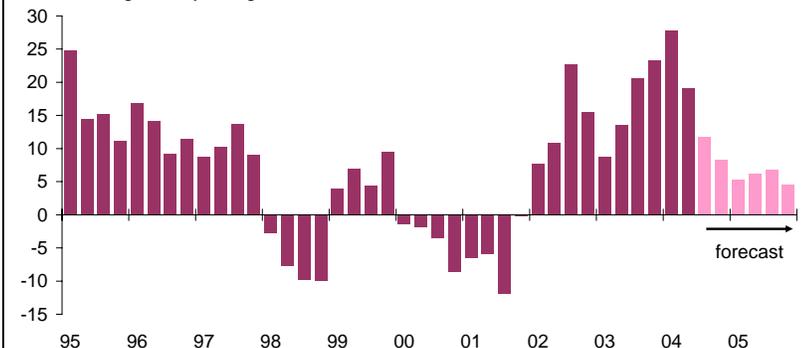
Nondefense, Nonaircraft Capital Goods Orders and Backlog  
Percent change from a year ago



Source: Census.

**Slower corporate profit growth may raise concerns about the outlook for job growth.**

U.S. Corporate Profits from Current Production  
Percent change from year ago



Source: Bureau of Economic Analysis, Macroeconomic Advisers forecast

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## Higher Commodity Prices Pose Risks to Hiring and Growth, Not Inflation

### High Input Prices Could Cut into GDP Growth

- Commodity and energy prices remain stubbornly high, taxing both businesses and consumers.
- Energy prices may not retreat soon. Global oil demand continues to build, while spare production capacity remains limited.
- A colder-than-expected winter could put further upward pressure on oil and natural gas prices in the short run.
- As long as energy prices remain elevated, non-energy businesses may spend and invest less, while consumers will have less money to spend on non-energy goods.
- A general rule of thumb: for every \$10 per barrel increase in the price of crude oil, real GDP growth declines by roughly 0.5 percentage points.

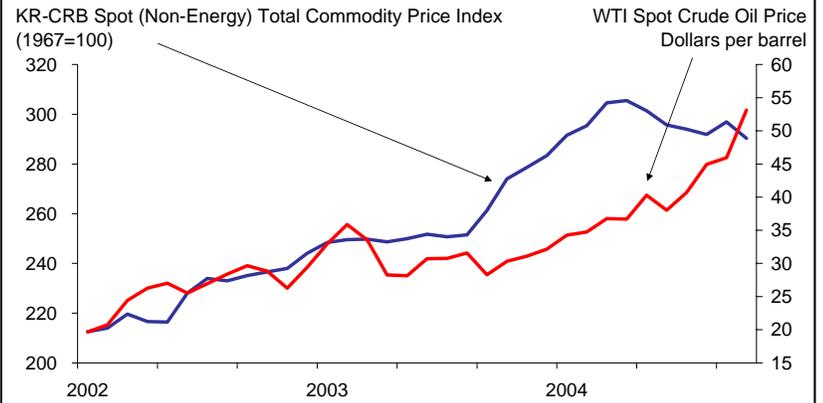
### 1970s-Style Inflation Does Not Appear Likely

- Despite the recent jump in oil prices, the economy is not likely to see runaway inflation anytime soon, because...
- The structure of the U.S. economy is fundamentally different today than in the '70s. For example...
- Today there is greater labor productivity, a less energy-intensive U.S. economy, lower inflation expectations, global price competition, and the reduced unionization and wage-bargaining power of workers.
- These factors may make it harder for price shocks to translate into a sustainable acceleration in inflation.

### Inflation and Interest Rates May Move Modestly Higher

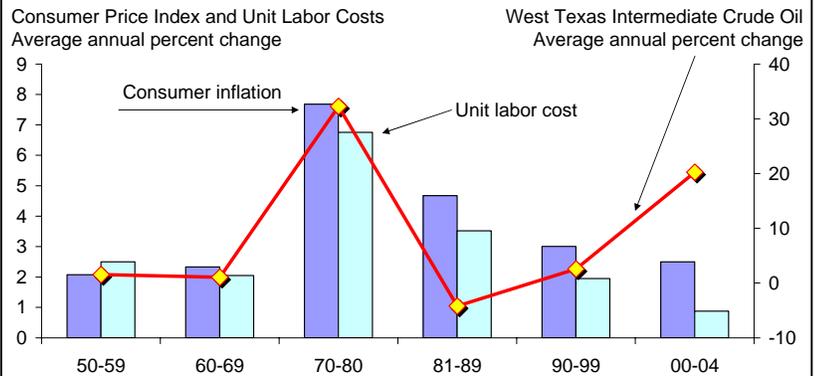
- Inflation could heat up over the near term, but it should remain below 4 percent—quite low by historical standards.
- This should allow interest rates to continue to rise gradually over the next year.

### Elevated energy and commodity prices are likely to linger for some time.



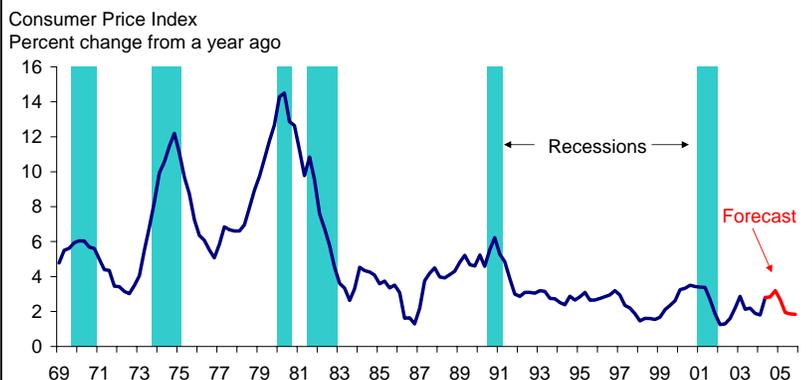
Source: Haver Analytics.

### Unique aspects of the 1970s economy allowed oil price shocks to more readily translate into higher labor costs and rising inflation.



Source: Bureau of Labor Statistics, Haver

### Any further acceleration in inflation over the next 18 months is likely to be short-lived.



Source: Bureau of Labor Statistics, Macroeconomic Advisers.

# Economic Conditions and Emerging Risks in Banking

## The Outlook for Consumer Spending May Be More Uncertain

### Tax Cuts No Longer Boosting Gains in Take-Home Pay

- The last round of tax cuts are no longer boosting after-tax income growth.
- This puts a greater onus on hiring and pay raises to boost both top-line and after-tax incomes.

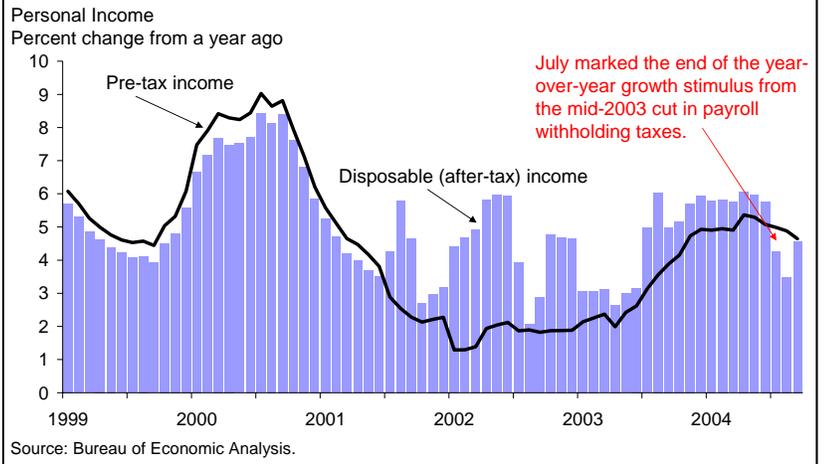
### Consumer Spending May Slow to a More Sustainable Pace

- Inflation-adjusted retail sales growth decelerated over the summer, although services spending held steady.
- Income gains and oil/energy prices will determine the strength and durability of consumer spending over the next year.
- Past evidence suggests that rising energy prices have a greater effect on lower income household budgets.
- Consumers continue to tap homeowner equity but increasingly through HELOCs, as refinancing activity has waned.

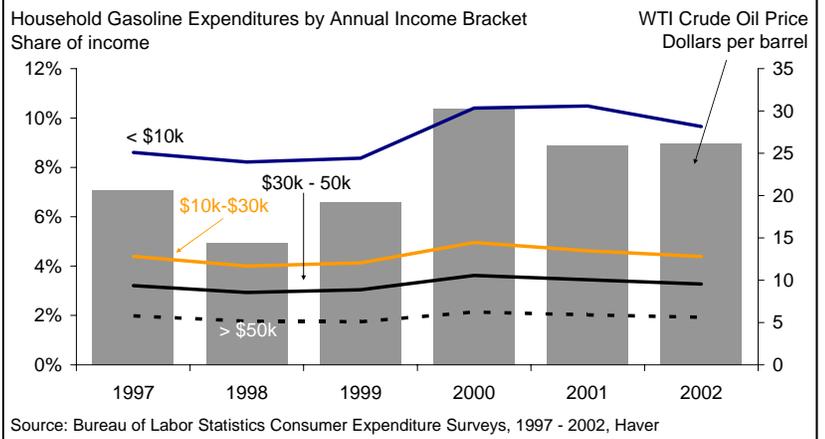
### Despite Co-Dependent Trade Relationship, China Is Moving to Float Its Currency

- Evolving global trade patterns have resulted in a “co-dependent” relationship between Asian exporters and U.S. consumers.
- Because of this relationship, Asian nations have pursued currency management policies to keep prices low and bolster U.S. demand for Asian-made goods. Recycling of dollars raised from trade and currency management also are supportive of low U.S. interest rates.
- The People’s Bank of China recently announced it will approach currency reform in a “gradual and steady manner,” perhaps indicating it would soon float its currency.
- Still, the risk of an imminent dollar collapse remains remote—a sharp dollar devaluation would lift U.S. interest rates and import prices, weighing on U.S. economic growth.

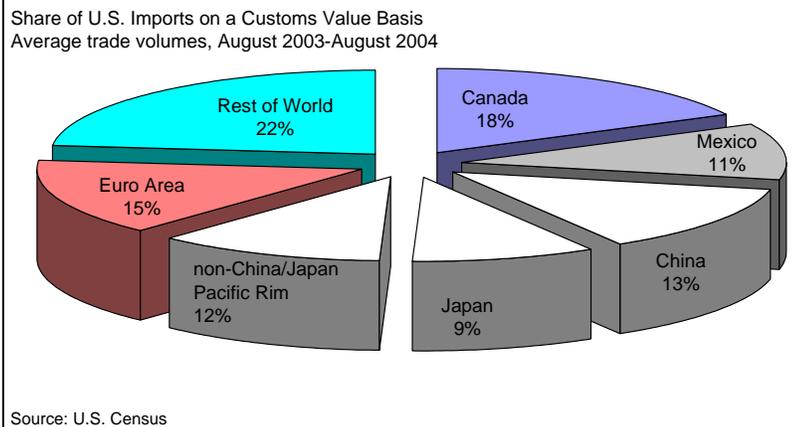
### Tax cuts are no longer boosting gains in take-home pay.



### Rising oil and gasoline costs have a greater impact on lower-income household budgets.



### China and Japan account for over one-fifth of U.S. imports, and the entire Pacific Rim over one-third.



# Economic Conditions and Emerging Risks in Banking

## Homeowners May Continue to Tap Equity, but Risk Exists

### Homeowner Equity Continues to Rise

- Despite a record volume of cash-out refinancing activity in 2003, total homeowner equity has continued to increase.
- This has been due to rapid home price appreciation and rising homeownership.
- Although many homeowners may still be able to tap the equity in their homes, high leverage in some markets raises concern.

### Rapid Home Price Gains Have Raised Concerns about a Housing Bubble

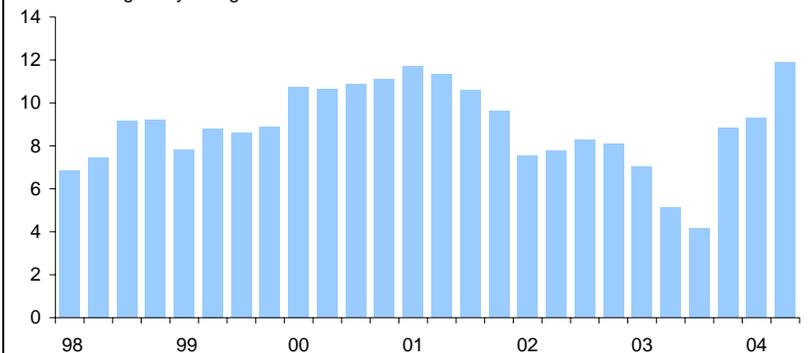
- During the past four years, U.S. home price appreciation has been about 50 percent faster than growth in disposable incomes.
- This rapid appreciation has raised concerns over the potential for a bubble in U.S. home prices and price declines if interest rates rise.

### If Home Prices Correct, It May be Possible to See More Declines in Nominal Prices

- While systemic factors such as interest rates can affect overall home price trends, local supply and demand factors play a greater role in driving home prices.
- Still, many of the nation's major cities may have experienced unsustainable rates of home price appreciation in recent years.
- Many of these markets have seen wide swings in home prices in the past.
- Historically, most home price busts tended to occur in real terms, as nominal values stagnated and real values failed to keep pace with inflation.
- In the current low-inflation environment, however, home price corrections today may be more likely to see nominal price declines.
- This could result in more significant adverse effects on consumer spending behavior than past home price corrections.

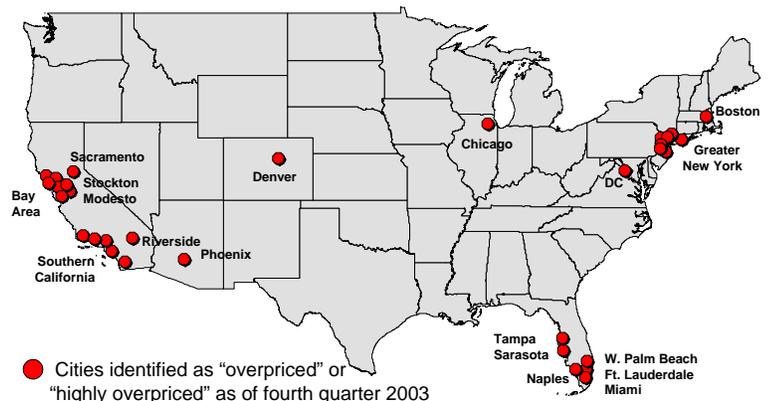
**Despite heavy refinancing activity in recent years, total homeowner equity has risen because of rapid price appreciation and increased ownership.**

Owners Equity in Residential Real Estate  
Percent change on year ago



Source: Office of Federal Housing Enterprise Oversight, Federal Reserve

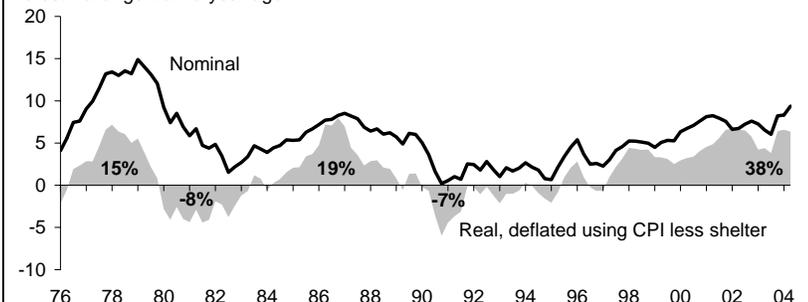
**Some cities may be more likely than others to experience a home price decline, given some negative economic shock.**



Source: Economy.com

**In the event of a correction, nominal home price declines may be more likely in the current low inflation environment.**

Paired-Sales Home Price Index  
Percent change from a year ago



Source: Office of Federal Housing Enterprise Oversight, Bureau of Labor Statistics.

Concept from: McCarthy and Peach, "Are Home Prices the Next 'Bubble'?" FRBNY Economic Policy Review, 2004, <http://www.newyorkfed.org/research/epr/forthcoming/mccarthy.pdf>.

# Economic Conditions and Emerging Risks in Banking

## 2004 Is Shaping Up to Be a Good Year for Banking Industry Earnings

Second quarter 2004 ended a five-quarter record earnings streak for FDIC-insured institutions, but earnings and capital ratios remain near historic highs.

### Factors That Could Further Boost Bank Earnings

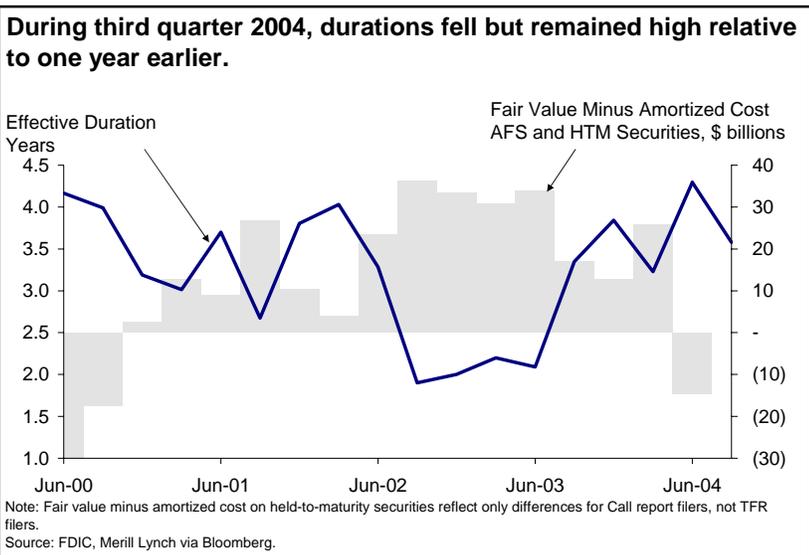
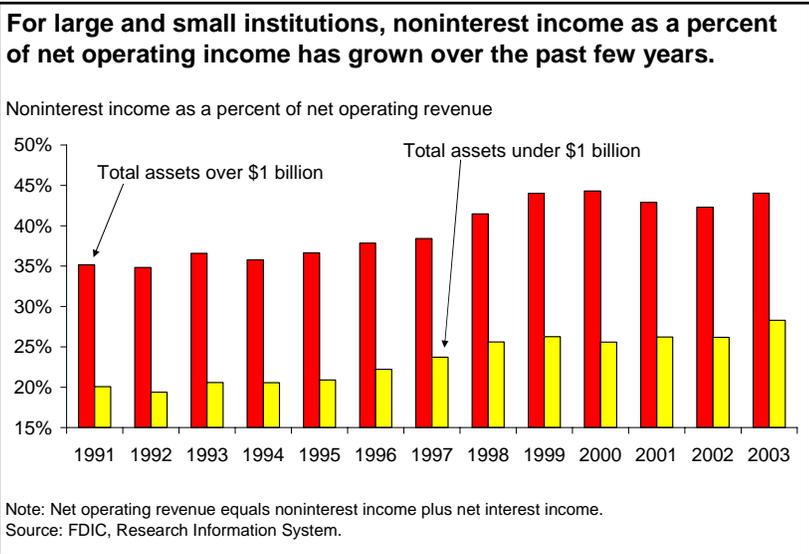
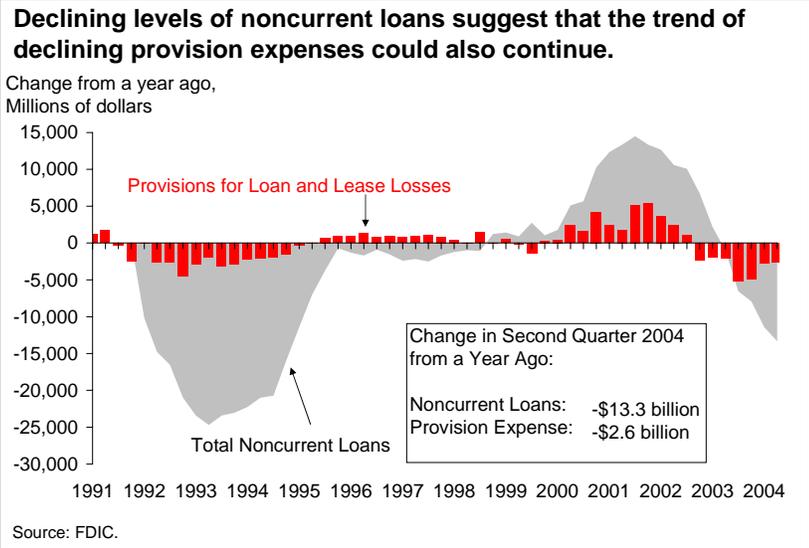
- Total industry provision expenses appear likely to decline further in the short run, as coverage of nonperforming loans continues to improve despite reduced provision expenses.
- Except for mortgage specialists, net interest margins may improve as interest rates rise.
- Lenders will be slow to boost deposit rates, while variable-rate portfolios should get a quick boost from rising short-term rates.
- With the end of the home refinancing boom, mortgage lenders with heavy fixed costs will consider restructuring measures to cut expenses.
- Rising interest rates will increase the value of mortgage servicing assets, thereby boosting fee income for mortgage servicers.

### Near-Term Challenges to Earnings Growth

- Rising rates will limit gains from the sale of debt securities, and pending accounting changes could result in the recognition of unrealized losses.
- Also, slower retail loan growth will raise the visibility of noninterest expenses associated with expanded branching activities.

### Bottom-Line Earnings Outlook

- Earnings should see a solid 2004 at a minimum; another record earnings year is possible.
- Cyclical/systemic risks exist but are well-monitored.
- Rising risks in HELOCs and C&I portfolios are still well out on the horizon.



# Economic Conditions and Emerging Risks in Banking

## Mortgage Lenders Will Be Challenged by Rising Interest Rates

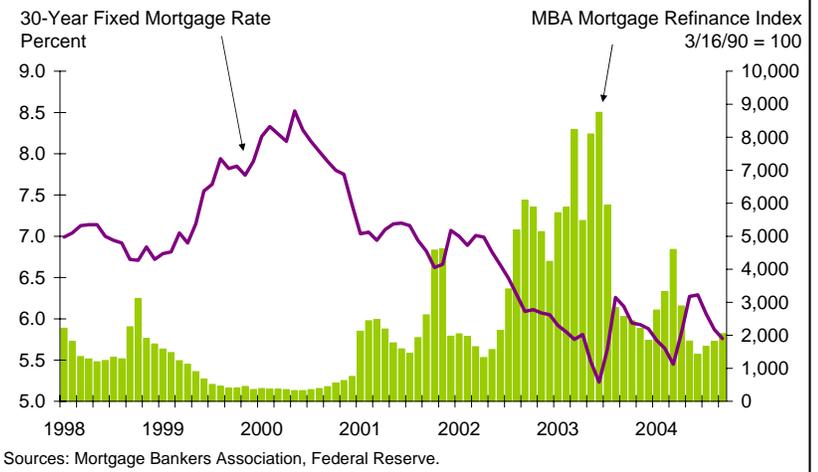
### Rising Interest Rates Pose a Particular Challenge for Mortgage Lenders

- The 2003 refinancing wave has largely subsided following a brief “mini-boom” in first quarter 2004.
- Lenders that increased capacity last year are now cutting overhead costs as volumes continue to tail off.
- Unrealized gains on portfolios of long-term, mortgage-related assets turned to losses as rates rose in the second quarter, removing potential future earnings boosts that have consistently come from gains on the sale of assets since late 2000.
- Net interest margins could narrow as rising short-term rates lift funding costs.
- The lengthening duration of mortgage portfolios and a decline in mortgage loan growth likely will cause asset yields to rise more slowly than funding costs. Increases in the value of mortgage servicing rights will provide income for some mortgage banks.
- Mortgage lenders will continue to look to riskier forms of residential lending, such as interest-only, high loan-to-value, and rehab loans.

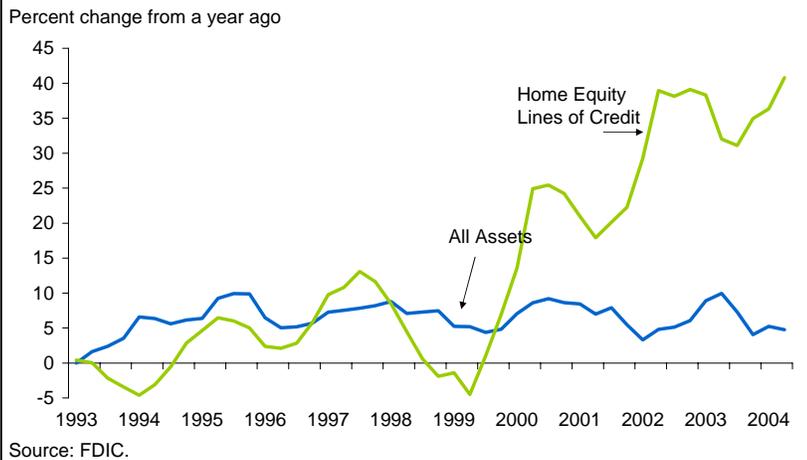
### Home Equity Loans Figure Prominently in Bank Portfolios

- After the fourth straight year of double-digit growth, home equity loans are the fastest growing asset class for commercial banks.
- HELOCs have more than doubled as a percentage of bank loans—from less than 3 percent in second quarter 2000 to more than 7 percent of bank portfolios as of second quarter 2004.
- Although loan performance is strong, this may be indicative of a highly unseasoned loan portfolio.
- Moreover, credit concerns are rising due to high household debt and riskier HELOC structures whose credit risks may not become apparent for some time.

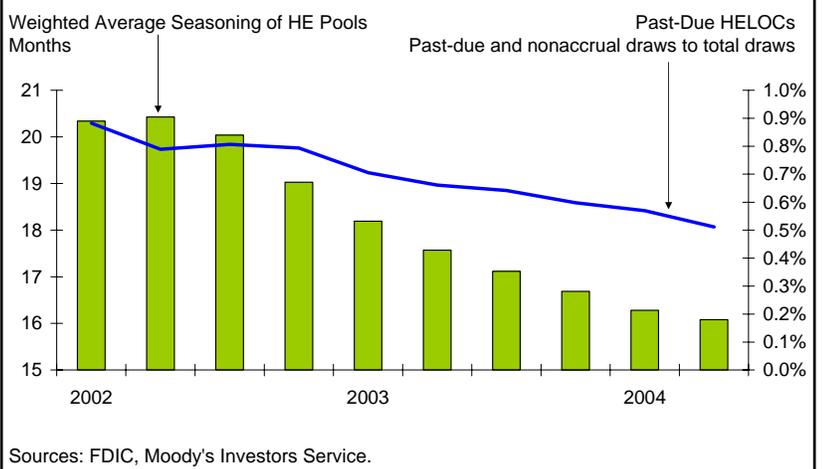
The sharp drop in mortgage refinancing activity will put pressure on lenders to cut costs, pricing, or credit quality.



Home equity loans are the fastest growing asset class on financial institution balance sheets.



Improving loan performance, however, may indicate that home equity loans are highly unseasoned and may mask credit risk.



# Economic Conditions and Emerging Risks in Banking

## Real Estate Portfolios Face the Most Immediate Risk from Rising Rates

### Real Estate and C&I Are at Different Points in Their Loan Cycles, So Credit Risk Will Vary

- Potential credit risks from higher interest rates are already embedded in variable-rate real estate portfolios underwritten in the past few years.
- *Future* credit risks for commercial lenders will be determined by the decisions made today to capture new business in the current rising-rate environment.

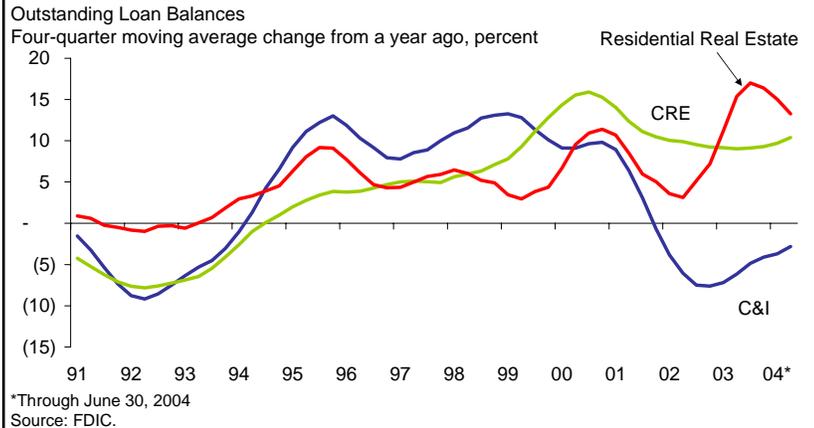
### CRE Portfolios Are Performing Well, but Losses Could Rise

- Aggregate CRE concentrations continue to trend upward with the ratio of CRE to Tier 1 capital in second quarter 2004 at 157 percent but remain below the peak of 314 percent in 1987 at the peak of the last cycle.
- Rising interest rates will push cap rates higher, causing increases in loan-to-value ratios. Higher interest rates will also cause debt-service coverage ratios to decline.

### C&I Loan Quality Should Continue to Improve in 2004, but Weakening Underwriting Standards Are a Future Concern

- Declining speculative-grade bond default rates suggest that C&I loan quality will continue to improve through 2004.
- C&I loan demand has been weak since 2001 but is now strengthening. Many banks are targeting commercial customers more aggressively.
- Spreads remain narrow on C&I loans for all firm sizes through second quarter 2004 primarily due to aggressive competition from both other banks and nonbank lenders.
- Thus, competition for emerging C&I business could lead to a further loosening of underwriting standards. In addition, with rising interest rates, lenders may be tempted to cut into C&I margins to add business.

**Rising interest rates may hurt real estate borrowers' credit performance, while commercial lenders may weaken underwriting or pricing to maximize revenue growth.**



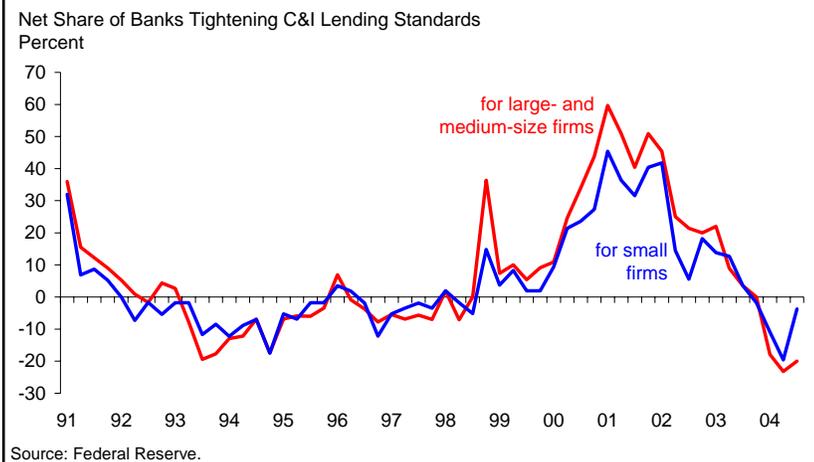
### Rising Interest Rates Cause Debt Coverage Compression on CRE Loans

**For a Sample Loan with These Characteristics and a 15-Year Amortization Schedule:**

NOI	Cap Rate	Value	LTV	Loan
\$100,000	8.0%	\$1,250,000	75%	\$937,500
Coverage Shrinks as Interest Rates Rise:				
Rate on Loan	5.5%	6.0%	6.5%	7.0%
Coverage Ratio	1.07X	1.03X	1.0X	0.97X

Source: FDIC.

### Banks continue to relax underwriting standards for larger commercial borrowers.



# Economic Conditions and Emerging Risks in Banking

## Potential Shocks That May Threaten Industry Stability

The close attention paid by banks and regulators to credit and interest rate trends probably reduces the likelihood of a large systemic problem for the industry in these areas.

A significant banking industry problem might be more likely to result from a sudden, and as yet unforeseen, shock that could destabilize financial markets, local economies, or the global economy.

### Financial Market Disruptions

- Two broad areas of concern continue to be increasing risk in derivatives markets and the complex and opaque positions taken by the fast-growing hedge fund sector.
- The ability of the financial markets to absorb the shock that would result from the exit of a large derivatives dealer or collapse of a group of large hedge funds is untested.

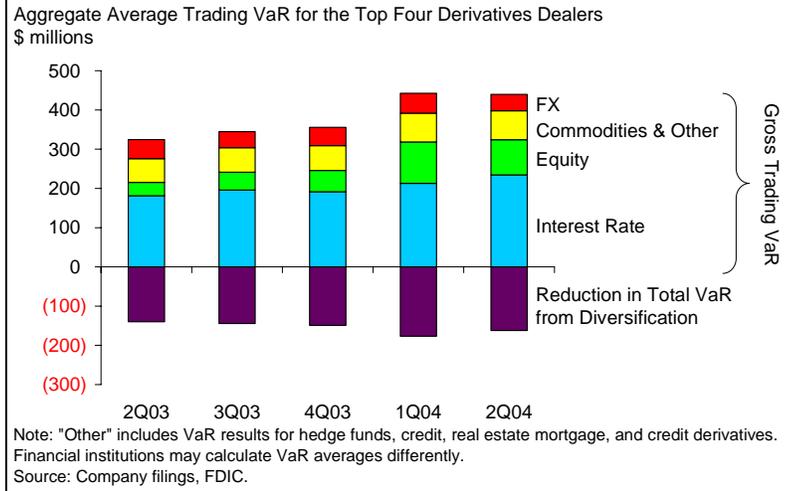
### “Stroke-of-the-Pen” Risks

- Farm subsidies totaled approximately \$19 billion in 2003, and the value of the mortgage interest deduction was worth \$331 billion to U.S. homeowners in 2001.
- A reduction in cotton and other subsidies in the next few years is at least conceivable.
- Other “stroke-of-the-pen” risks include major changes to accounting rules or other regulations that would upset the future economics of current business strategies.

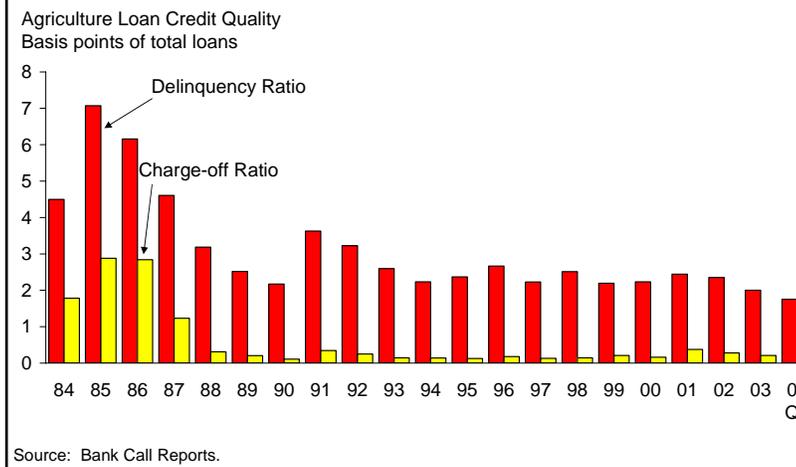
### Global Economic Shocks

- A dramatic slowdown in China’s economy could exert downward pressure on the export volumes of other Asian economies and world commodity prices, which could possibly result in a global recession and renewed global deflationary pressures.
- Strong demand and tight excess production capacity has significantly raised the risk that a protracted period of elevated oil prices may derail the global economic expansion.

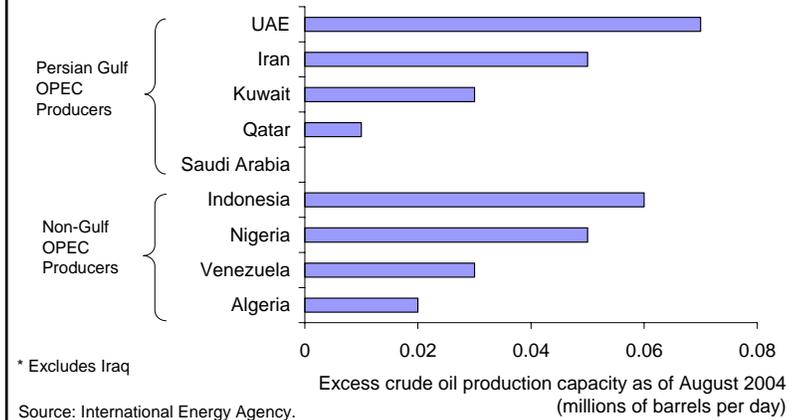
Value at Risk (VaR) from trading activities has grown in the past year.



Commercial bank delinquency and charge-off rates for agricultural loans remain low.



Spare OPEC\* crude oil production capacity remains tight with Saudi Arabia at full capacity. Spare capacity among non-OPEC producers is negligible.



# Economic Conditions and Emerging Risks in Banking

## Banker Perceptions of Risk and Market Opportunities

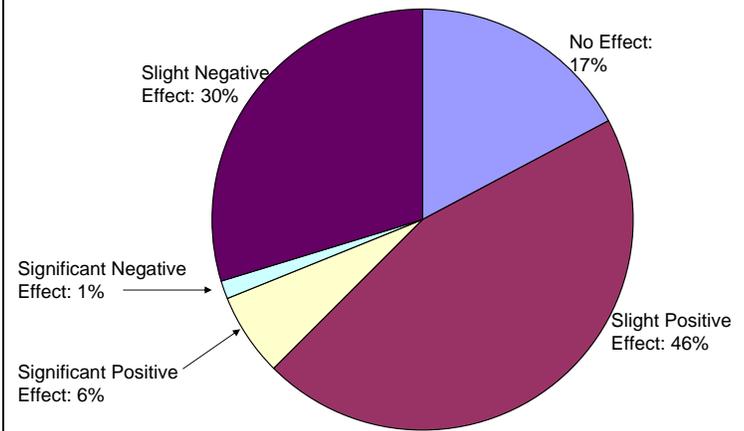
### Third Quarter American Banker Survey Queried Bankers on Rising Interest Rate Concerns

- Bankers did not express great concern for the effect of rising interest rates on near-term earnings, according to a recent American Banker/Insights Express survey.
- Fifty-two percent felt rising rates would have a slight or significant positive effect on earnings, while 31 percent said rising rates would have a slight or significant negative effect.
- Respondents ranked rising interest rates as the second-greatest risk concern. While 36 percent ranked fraud/privacy as the greatest risk, 20 percent felt rising interest rates posed the greatest concern.
- Assessments of risks differed by institution asset size. Larger institutions—those over \$20 billion in assets—viewed rising interest rate risk on par with disaster recovery risk at 15 percent.
- Institutions with less than \$20 billion in assets ranked rising interest rates as a higher concern at 22 percent. Both large and small institutions ranked fraud/privacy risks as the greatest concern facing their institutions.
- Larger institutions ranked compliance with Basel II capital rules at 15 percent of their overall concerns.

### Bankers Are Looking to HELOCs

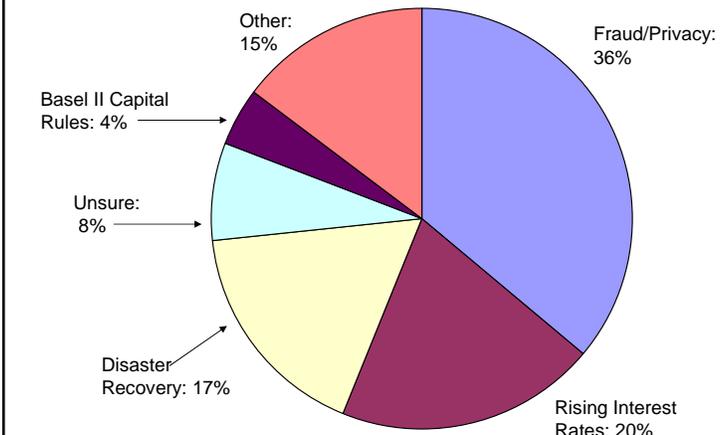
- Lenders are targeting other loan growth opportunities, specifically home equity lending, to take up the slack from the decline in refinancing activity and 1-4 family mortgage production.
- The challenge for lenders is not only to make new home equity loans, but also to get customers to use them.
- The utilization rate for HELOCs is 48.9 percent as of second quarter 2004, leaving \$435.2 billion in unused commitments.

Most bankers expect rising interest rates to have either no effect or a slightly positive effect on earnings in 3rd quarter 2004.



Source: American Banker/InsightsExpress Executive Forum 3Q 2004, FDIC.

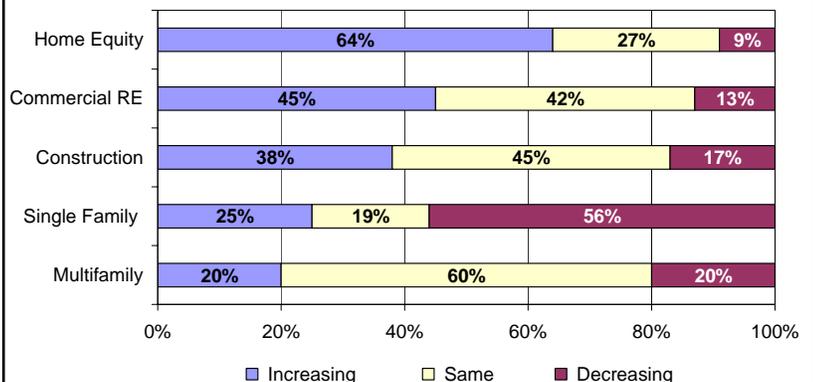
To most bankers surveyed, rising interest rates are the biggest risk management concern after fraud/privacy.



Source: American Banker/InsightsExpress Executive Forum 3Q 2004,

Loan production efforts are targeting home equity lending over other loan types.

Estimated changes in loan production in 2004:



Source: ACB 2004 Real Estate Lending Survey.